# DOW THEORY LETTERS INC.

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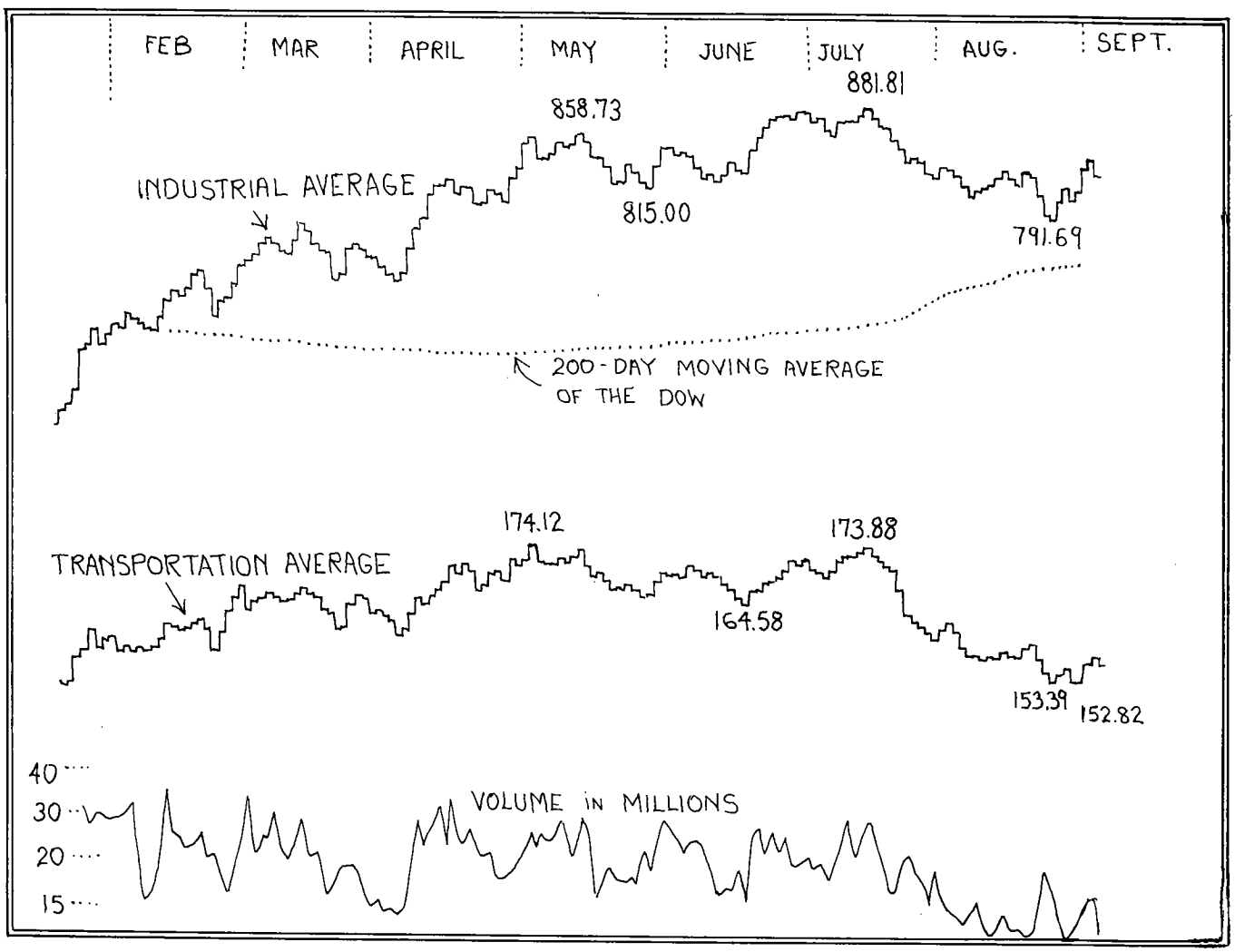
September 5, 1975 Letter 641

THE MARKET: I really should start this Letter off with some comments on gold. Gold hit $149 in London today. I guess that makes me think of the old stock market adage, "Don't tell me what to buy, tell me when to buy it." I ceased being a gold-bug last year when I felt that the gold bull market was over and that a primary bear market in gold had begun. My goldphile friends blasted the hell out of me for this change of stance. But my fellow advisors don't pay the bills here, my subscribers do. Therefore, I felt I should continue to give it to my readers straight regarding gold, rather than try to please my friends in the business.

Those who sold out their gold shares (and bullion, although I am not particularly worried about the metal) have avoided some nasty moments and some fearful shrinkage of paper profits (and probably some whopping real losses). At any rate, another shoe has fallen for gold (the gold market seems to have more feet than a centipede and each foot wears a shoe).

On September 1, the IMF decided (under US pressure) to sell 25 million ounces of gold or one-sixth of their total holdings. Well, that knocked the metal down below $150, where I thought it might go, and now people are calling to inquire "How much further down?" I don't know, but bear markets generally go further than expected on the downside (which is why I never recommend riding them out). "Take your losses and lick your wounds," has always been my advice to people locked into a bear market. That requires humility, and unfortunately most people are proud. To put it mildly, today's situation is a difficult one for gold share holders (more later).

As for the stock market itself, I include a chart on page 2 (courtesy of M/G Financial Weekly) showing all the major advances (and I'm talking about advances of 28% or more in the Dow) since 1897. As you can see, the 1974-75 rise con-



sumed only 151 trading days. There has been only one advance of shorter duration (over 28%) in market history, and that was in 1939. What does this tell us? It says that the odds favor this bull market going longer and going higher before it is over. But those are only the odds, not a crystal ball reading, and as veteran readers know, I deal with probabilities, not promises (which is one of the reasons I've managed to last in this business for seventeen years).

**Dow Jones Industrials**
**Major Advances (1897-1975)**

| From | To | DJIA | Pts. | % | Tdg. Sess. |
|---|---|---|---|---|---|
| 04/23/97 | 09/05/99 | 38.49 to 77.61 | 39.12 | 101 | 709 |
| 09/24/00 | 06/17/01 | 52.96 to 78.26 | 25.30 | 48 | 214 |
| 11/09/03 | 01/19/06 | 42.15 to 103.00 | 60.85 | 144 | 659 |
| 11/15/07 | 11/19/09 | 53.00 to 100.53 | 47.53 | 90 | 600 |
| 09/25/11 | 09/30/12 | 72.94 to 94.15 | 21.21 | 29 | 305 |
| 12/24/14 | 11/21/16 | 53.17 to 110.15 | 56.98 | 107 | 577 |
| 12/19/17 | 11/03/19 | 65.95 to 119.62 | 53.67 | 81 | 552 |
| 08/24/21 | 09/03/29 | 63.90 to 381.17 | 317.27 | 497 | 2402 |
| 07/08/32 | 03/10/37 | 41.22 to 194.40 | 153.18 | 372 | 1390 |
| 03/31/38 | 11/12/38 | 98.95 to 158.41 | 59.46 | 60 | 187 |
| 04/08/39 | 09/12/39 | 121.44 to 155.92 | 34.48 | 28 | 131 |
| 04/28/42 | 05/29/46 | 92.92 to 212.50 | 119.58 | 129 | 1211 |
| 06/13/49 | 04/06/56 | 161.60 to 521.05 | 359.45 | 222 | 1807 |
| 10/22/57 | 01/05/60 | 419.79 to 685.47 | 265.68 | 63 | 554 |
| 10/25/60 | 12/13/61 | 566.05 to 734.91 | 168.86 | 30 | 284 |
| 06/26/62 | 02/09/66 | 535.76 to 995.15 | 459.39 | 86 | 909 |
| 10/07/66 | 12/03/68 | 744.32 to 985.21 | 240.89 | 32 | 500 |
| 05/26/70 | 01/11/73 | 631.16 to 1051.70 | 420.54 | 67 | 665 |
| | | **Average.** | 161.30 | 121 | 759 |
| 12/06/74 | 07/15/75 | 577.60 to 881.81* | 304.21 | 53 | 151 |

* Validity of high not proven.

Turning to the page 1 chart of the Averages, note that the two components, Industrials and Transports, recorded joint lows for the July-August decline on August 21, Industrials at 791.69, Transports at 153.39. Following a two-day rally, the Averages turned down again, and this time Transports sunk to a new low of 152.82 (Aug 27) but Industrials refused to confirm. This minor non-confirmation set off a rally in which Industrials bettered their recent August peak, but note that Transports remained discouragingly sluggish.

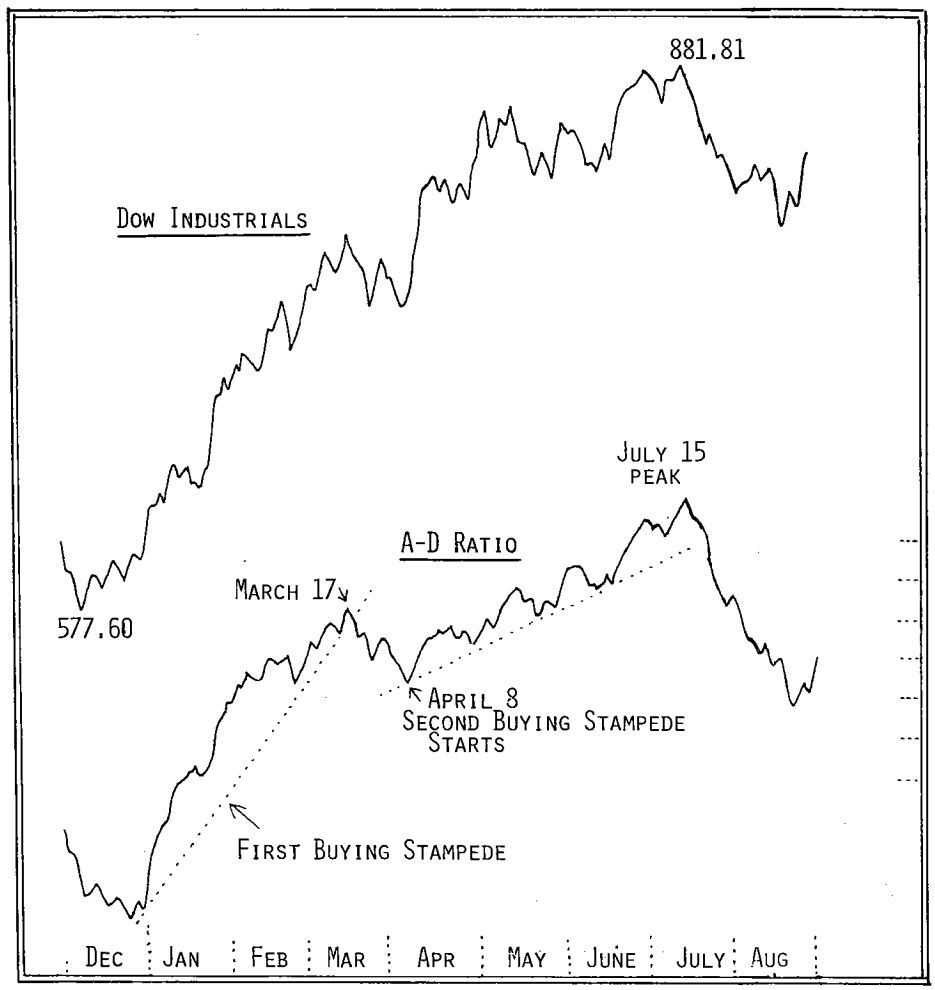
What happens next? We have a situation now in which the market is still very compressed on the downside, very "sold out." Yet I continue to feel that the odds are better than even that we will get another downward leg for this reaction, one which could take the Averages to new lows during October to December. The best I see here is a series of confusing and costly trading rallies leading to upside non-confirmations. The worst I see is a continuance of the secondary decline, ultimately carrying the Dow down to or perhaps below the 700 level.

Either choice leaves cash as king of the current situation. As I've been saying so often in these reports, 1975 is fated to be an interesting year and profitable year for many of us. But it's not going to be a gravy train as were so many of the previous "five years" (for instance, 1935, 1945, 1955, 1965). The monetary problems are too severe here in 1975, the money noose is too tight around the American neck. It's a sad time for the nation when the stocks of its corporations rise simply because the monetary noose is loosened a bit. But that's where we are. So I ask myself, why pretend you're being caressed by your fantasy lover when, in reality, you're in the grip of a python.

ADVANCE-DECLINE RATIO: The great smash of 1973-74 ended on December 23, 1974, as far as the great majority of stocks is concerned. The advance-decline ratio turned up on December 24, and the resultant massive buying wave materialized into what I termed a "buying stampede." The stampede ended on March 17, and it was followed by a drop of 2.25 points (any drop of over 1 point in the A-D ratio is sufficient to terminate a buying stampede).

On April 8 the market turned up again, and a second but much milder buying stampede followed. Over the next three months the A-D rose a total of 5.20 points. The second stampede ended on July 15. What followed was most extraordinary, and it was almost as if the market abruptly changed its mind on the whole forthcoming business and profit picture.

As you can see on the chart, the A-D ratio (between July 15 and August 26) dropped an astounding 5.79 points. Now, just as a 1 point drop in the A-D ratio following a buying stampede served to terminate the movement, so a 5 point or more drop in the A-D, following a major rise, served to tell us something very important. How



did I arrive at the 1 point and 5 point criteria? Past history, observation, and study is the answer (you might call it trial and error). It has been my observation that in the past whenever the A-D ratio drops 5 points or more after a major rise, the result is an extended period of decline, consolidation or upside non-confirmations.

If you study the chart you will note that (1) the drop from the July 15 peak was both violent and extended, and by extended I mean over 5 points. (2) The decline not only wiped out all the gains of the second buying stampede (which began from the April 7 low) but took the A-D ratio back to its level of January 30! That is a lot of downside action for a single month!

Based on my studies of past advances which ended with declines of 5 points or more in the A-D ratio, I would say that the odds are now against a major recovery in the market this year. This does not mean that the Dow cannot mount a solo recovery, but a new high on the Dow without confirmation on the part of the A-D ratio would just constitute a signal for more trouble ahead.

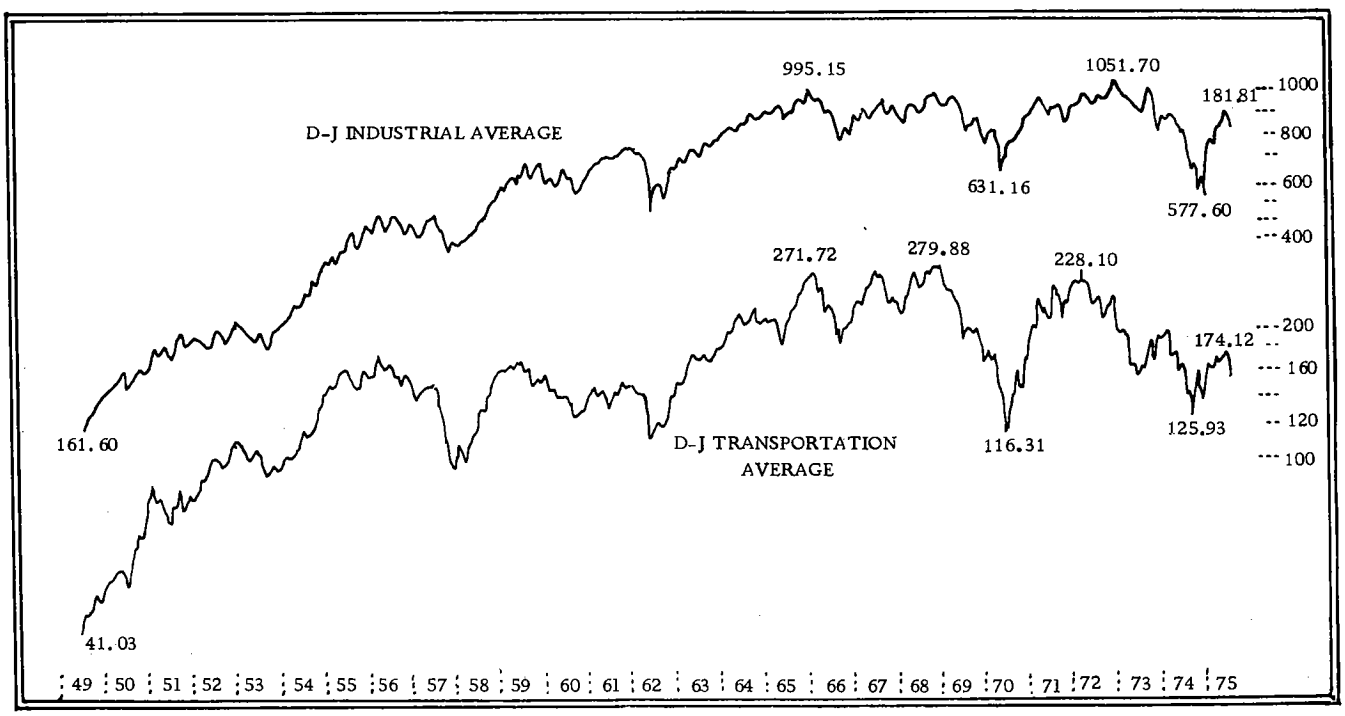
My next observation is that most declines of 5 points or more in the A-D ratio are followed by renewed selling, once the first rally has spent itself. Thus, the fact that the Dow and the A-D hit lows in late-August is not that comforting, and the fact that the market has been rallying is not the answer to an investors' prayers. Past case histories suggest that there will be more trouble ahead, more selling, and lower prices prior to a major bottom and "buy spot."

Whatever the market foresaw during July-August which caused the A-D ratio to tumble back to its late-January level cannot be particularly pleasant or hopeful. My guess is that forthcoming problems have to do with the money markets, interest rates and the sluggish pace of business. If interest rates rise from here, business may collapse. If interest rates do not decline, business will remain weak. If interest rates do decline, inflation may become rampant. Maybe Mr. Burns or Mr. Ford has the answer to the situation (whatever became of Simon and Greenspan? They don't seem to say much anymore).

LONG-TERM: One of the major debates going on today is this: "Does the rise since late-1974 represent a major correction in an ongoing bear market or does the advance constitute the first upward leg in a new primary bull market?" The chart I am presenting traces the path of the D-J Industrial and Transportation Averages from 1949 to date. Since the chart is drawn to semi-logarithmic scale, all movements are shown in percentages. Thus, advances and declines in the two Averages can be properly compared (for instance, a rise of 10% in Industrials will take up the exact vertical distance as a 10% rise in Transports, even though the value of the two Averages are different).

The first thing to note is that the great bull market which began on June 13, 1949 ended on February 9, 1966. That was the date of the last confirmed highs in the two Averages. The bull market ended with Industrials at 995.15 and Transports at 264.82. Although each Average subsequently closed higher, at no time did they both better the 1966 marks. Therefore, under Dow Theory this unusual bull market ended on February 9, 1966.

The primary bear market which followed was as exotic as the bull market of 1949-66. During the initial crash of 1969-70, Industrials closed at 631.16 while Transports halted at 116.69. A new rise carried into 1973, at which time Industrials exploded to 1051.70 (January 11, 1973). The all-time high in Industrials (see chart) was not confirmed by the Transports, and this constituted one of the most important non-confirmations in stock market history.



In January, 1973, the Averages turned down again, setting off the worst slide since the 1930's. By late-1974 the Industrials had dropped to 577.60. Inexplicably, the Transports stopped at 125.93, actually nine points above their 1970 low. Why, then, you ask, was not 1970 the year of the true bear market low. After all, 1970 represented the period of the last confirmed lows in the two Averages?

That question is one of the most baffling I have ever had to contend with. And to be honest with readers, I base my answer on my own intuition plus the fact that the Industrials, Utilities and the A-D ratio did continue down to lows which were reached not in 1970, but in 1974. Therefore, I arbitrarily stated that the bear market was continuing (I said this all during the early 1970's). And I later wrote that for a number of reasons I felt that the bear market ended in October-December, 1974.

But the question can be asked, "What would it mean if somewhere ahead the two Averages crashed to new lows, Industrials under their 1974 low of 577.60 and Transports below their 1974 low of 125.93?" In that case, I would certainly hang my head and agree that the bear market which began in 1966 was continuing. However, I will state here and now that I would be amazed if the two Averages crash to new lows below the 1974 lows.

The 1966-74 bear market was a long one (eight years). It practically annihilated the A-D ratio. It took Industrials down to a level only 50 points above the 1956 high. It took Transports back to their 1954 level, it took the A-D ratio back to levels not seen since the 1930's. On the equity front, many stocks lost 70% to 90% of their peak values. All in all, it was apparent that a disaster had overtaken Wall Street. As I have written so many times, the market at the 1974 lows had discounted everything short of the collapse of the US and the fall of the West. There was no doubt about it in my mind, stocks were great values in late-1974.

In answer to the question of whether we are moving towards a resumption of the bear market and a forthcoming collapse to new lows, I can only say that I doubt we will witness anything like that in the period ahead. I can see a correction, even a severe correction, but I sincerely doubt that we will see a new crash which would take the whole market structure down to levels below the extreme lows seen at the end of 1974.

The market's function is to discount, to look ahead. An eight year bear market (roughly half as long as the preceding bull market) and a horrendous collapse in the great majority of stocks should suffice to discount the worst. I believe it did. I do not see the lows of 1974's being broken during at least the several years ahead.

INFLATION OR NOT? Subscribers to these reports include some of the best minds in the Free World. When it comes to any subject from Xerox to the trend of the market to the meaning of scrap steel prices to the fundamentals of inflation, I can count on my subscribers to come up with some of the best information and observations available.

I doubt whether any subject receives more attention these days than inflation. I probably receive ten letters a week dealing with this subject, and among the many I have received in 1975, undoubtedly one of the best comes via a report written by Mr. C.L. Constantinides of Geneva, Switzerland. Perhaps I liked this report so much because I agree with it, but at any rate Mr. Constantinides writes that "there is only one cause of inflation, and that is the expansion of the money supply (currency and credit) by the Federal Reserve Board." I certainly could not agree more.

By expanding the money supply endlessly, the Government is creating a situation wherein it requires a constantly increasing amount of money to purchase the same amount of labor and product. This is debasement of the currency, pure and simple. Why does the Government follow this policy? Because in order to "please" the voters, the Government finds that it is politically expedient to give the public "what it wants." Since the Government cannot raise taxes at will, it creates "new money" to pay for the programs that it decides the people want or "need."

Since July, 1974 the money supply ($M_2$ which is money stock plus net time deposits) has increased from $598 billion to over $650 billion. That's a jump of over $62 billion in a year, and it's inflation any way you look at it.

I have been saying for some time that the US is now past the point of no-return in its inflationary economics. What do I mean by that statement? I mean that if we hold level on the money supply or cut back, the US economy will slip into depression. The weight of the massive need for borrowing (both Government and private) would instantly run interest rates through the roof, business would collapse, and we would be in a depression almost overnight.

On the other hand, boosting the nation's money supply might give the illusion of a business expansion, at least for a while, and that is the way the nation is moving now. In other words, the big question now is whether to boost the money supply at a semi-rapid rate or a truly rapid rate. I am of the opinion that a mild rate won't work (the Fed tried that earlier in the year).

I have also been saying that we are at the point where the horse (the consumer) has to drink the water (the money) or else. Confidence on the part of the US consumer and businessman is low now, dangerously low. People distrust their Government, they distrust their institutions, they distrust even themselves. Perhaps it is symbolic that we now have our first non-elected President and Vice-President. US citizens, instead of having confidence in a representative Government, now feel harrassed and pushed-around by their Government. And in such a frame of mind, we must expect the unexpected.

One possibility is that public confidence will simply not be regained. If that happens, if people don't spend the way they "should," then no amount of Government monetary infusion is going to create a new boom. Instead, the current lull is going to give way to the unexpected, and that would be deflation and further liquidation of credit.

Mr. Constantinides writes that "inflations have always ended either with run-away inflation followed by repudiation or by a collapse in confidence short of run-away inflation which triggers a rush out of the debased money. Either way, deflation and depression follows."

Personally, I put the odds on run-away inflation over the next year or so at about 50/50, no more. I say that because I don't think Mr. Burns and Mr. Ford want it, and I think they could jam the inflation machine if they so desired. And I put the odds for collapse and deflation at about one chance in three, because the odds are always against disaster (and because I think the market has already discounted the worst possibilities for the next year or so). Finally, I feel the odds do favor more bungling, a continuation of skepticism on the part of the US populace, and probably a sprinkling of disasters throughout the coming year (disasters such as the NYC fiasco, the Japanese bankruptcies, a few more US bank collapses, disclosures of further immorality on the part of business and Government leaders).

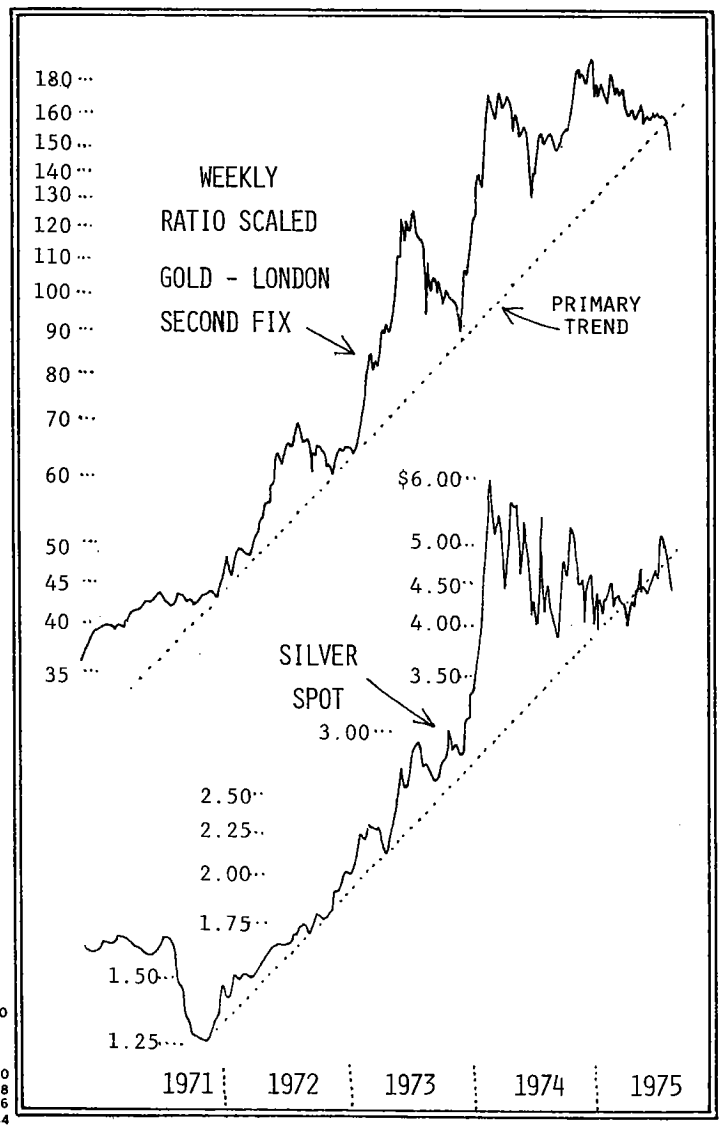
Of course, the great threat at this point is that of a chain reaction, of one emergency's setting off a Pandora's box of horrors. It all could happen if the initial disaster was big enough and public confidence was stretched to the absolute breaking point. New York City might give us a test of the whole situation during the few months ahead. In the meantime, I continue to be at least mildly skeptical of the almost universally held thesis that "inflation is in the bag" for the US during 1975 and 1976.

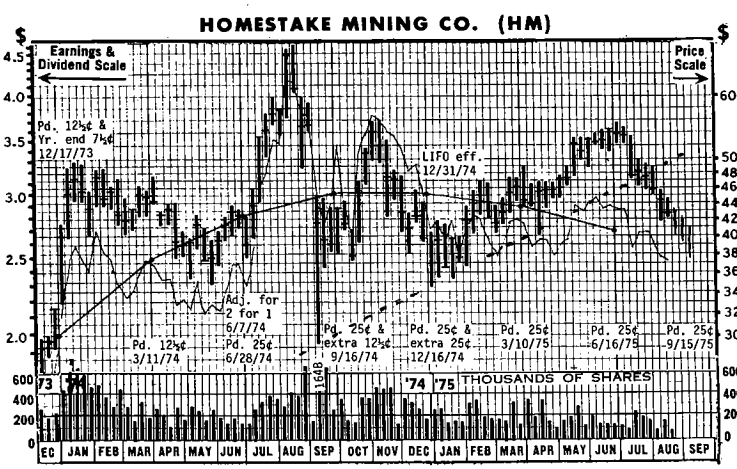
GOLD: It was all in the charts. Sometimes the charts just don't work. Most of the times they do. They did this time. I have been including my various gold and silver charts in Letter after Letter. I have already discussed how the primary bulltrend line has been violated by silver. I wrote in the last few Letters that gold was about to break below its rising primary bull trendline.

On September 1 London saw gold plunge to 155.25. On September 2, the day after Labor Day, gold sank further, to a price of 149.25. As you can see on my often-published chart of gold and silver, both of the precious metals have now broken down. I don't know where this decline is going to take gold and silver. But to those who were buying silver (even while gold tottered) I warned, "Leave silver alone. It will go the way of gold, and gold is acting sick." Last week silver broke 4.50 on the downside. It is heading down with gold. I don't know where the bottom is for the precious metals, and neither does anyone else.

We've been hearing about the 170 support level for gold, a support which France was supposed to honor. Then we heard about a 160 support level. Now 150 has not held. Margin calls are coming in for the bullion and gold shares. Fortunes are being lost, the pressure is on, and it's pressure brought on by fear.

Normally, a panic decline will be followed by an automatic 50% recovery of the ground lost, and this action will be





HOMESTAKE MINING CO. (HM)
Earnings & Dividend Scale
Price Scale
Pd. 12½¢ & Yr. end 7½¢ 12/17/73
LIFO eff. 12/31/74
Adj. for 2 for 1 6/7/74
Pd. 12½¢ 3/11/74
Pd. 25¢ 6/28/74
Pd. 25¢ & extra 12½¢ 9/16/74
Pd. 25¢ & extra 25¢ 12/16/74
Pd. 25¢ 3/10/75
Pd. 25¢ 6/16/75
Pd. 25¢ 9/15/75
'74 '75 THOUSANDS OF SHARES
EC JAN FEB MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP

followed by a renewed testing of the lows. I don't know where the automatic rebound will start from, and I think it's highly dangerous to try to catch it. Gold, in my opinion, could easily (under heavy selling pressure) come down to the 125 level, and as you see on the chart that would still leave it far above the 1973 low.

One thing I should mention here is that it's a very expensive proposition holding non-interest bearing metal in the face of bonds yielding 10% or more. And it's an expensive proposition holding gold mining shares in the face of rising mine costs (costs are going up at a rate of about 25% a year) even while the price of the product (gold) is dropping. That's what is known as the "double whammy," and the gold stocks are facing the double whammy right now.

I included a chart of Homestake in the last Letter, and I might as well up-date that chart now. The stock has fallen apart, and is testing the panic lows of September, 1974 (as I indicated it might). If the 29-30 area does not hold for HM, then we will have a signal suggesting that the situation for gold shares is changing from a panic into an unmitigated disaster. I hope we don't see that, but in a bear market (which golds are now in) the market makes its own lows — and logic often stands on the sidelines.

In the first quarter of 1975 industrial consumption of silver was down 33% from 1974. Industry is turning to silver substitutes. Bad news from S. Africa regarding the racial situation is not a fact yet, only a possibility. So what do we do regarding gold shares? In general, be glad that we're out of them, and exercise patience. There'll be a time to take on gold shares again, but in my opinion we're not there yet. Those who depended on gold to protect them from inflation have, over the past year, been on a rapid trip to the cleaners. It's ironic but true, and the only culprit has been timing. Ultimately, the golds will hit bottom, and then we will "Buy 'em at the market." But I repeat, I don't think we're there — yet!

LATE NOTES: The NYC situation is building up and up. And the market is coming down in order to protect itself. No one knows what to make of the thought of a NYC bankruptcy. It's like asking a mouse to describe his coming fight with an elephant. It's simply beyond his experience.

If the elephant goes under (and he's technically under already), it's a question of whether the Fed will pull him up again or whether the Fed looks away. If the Fed looks away, then there's no telling what happens next. The banks are up to their necks in NYC paper. The manufacturers, suppliers, unions, God knows, will all be involved. It could be the financial counterpart of the sinking of the Titanic.

The psychological implications are just as scary. If the unions and the workers keep pushing, and the City goes belly up, who will lend the money in the future? If the bond holders are written off or pushed aside as if they were second class citizens, where are the cites and states going to get money next week and next year?

As I said before, the "fat era" is coming to a close in America. Slowly but relentlessly, we're moving towards the period in which the piper will have to be paid — or the system will be changed.

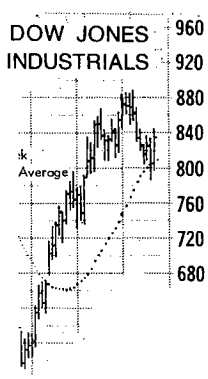
But before they try to change the system, the Government will make a last effort towards self-perpetuation. That means spending, and in order to spend they will require the long green, mountains of it.

How does one protect himself against all that? I would say out of hand that the only way I know is with common stocks, which are liquid and which move fast (vs. say real estate which is illiquid and which moves very slowly). What this market is probably doing now is building up technical strength, getting sold out, backing off to the "safety level." But out of this area should come a major and perhaps surprisingly extensive upward movement. It will represent a flight towards protection from currency debasement. I feel that timing will be the main problem in dealing with this coming advance. It might not start until the end of the year or possibly even until 1976. But it should come, and it should be a whopper.

CONFIDENCE: How's this for loss of confidence! The New York State tax anticipation notes maturing December 30, 1975, are quoted (today) to bid 97 for a tax-free (Federal) yield of 13%. And that's the best paper the State has!

I just spoke to Eliot Janeway in NYC and asked him about the situation. He says that the real problem is not what to do with NYC (he considers the City's collapse as "accomplished") but what the Fed is going to do about the banks that are swimming in NYC obligations. Personally, I would guess that the Fed will come to their rescue, and I think Janeway does too. Don't any of you cynics underestimate Janeway's shrewdness and knowledge regarding what's going on today. I know of no one who has been so "right on" in the area of gold and the current economic picture. To put it bluntly, Big Eliot is not happy with the way things are going in this land of ours, he's not happy at all (Gerald Ford, are you listening?).

FINAL OBSERVATION: As a rule, where there's smoke there's fire. And as a rule, where there is a "head-and-shoulders" top in the Dow, there's distribution. Here's a high-low and closing chart of the Dow, and that's a potential H & S top you're looking at. If the Dow drops below 790 the top would be complete. If not, there has still been a lot of distribution, and that usually spells trouble in due time. (Chart courtesy of CMI Business Serv., Bellevue WA 98009).




Next mailing: September 17th.